No. 319

In the Supreme Court of the United States

OCTOBER TERM, 1942

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v.

EDGAR B. SIMS ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

INDEX

CITATIONS

Statutes—Continued.

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MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

In the District Court the Securities and Exchange Commission became a party to the present proceeding for the reorganization of Fidelity Assurance Association under Chapter X of the Bankruptcy Act,[1] participated as an appellee before the Circuit Court of Appeals, and is named a respondent by petitioner here.

This memorandum is filed in support of the petition.

[1] The Commission appeared at the court's request pursuant to the provisions of section 208 of the Bankruptcy Act, as added by section 1 of the Act of June 22, 1938, 52 Stat. 894 (U. S. C., title 11, sec. 608).

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 363–387) is reported in 129 F. (2d) 442. The opinion of the District Court (R. 3–38) is reported in 42 F. Supp. 973.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 16, 1942 (R. 387–388). A petition for rehearing (R. 389–393) was denied July 22, 1942 (R. 397). Jurisdiction of this Court is invoked under section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether petitioner association was an "insurance corporation" within the meaning of section 4 of the Bankruptcy Act when it filed a petition for reorganization as a corporate debtor.

2. Whether the court below erred in holding that the petition had not been filed in good faith within the meaning of section 146 (3) and (4) of the Bankruptcy Act.

STATUTES INVOLVED

Section 4 (a) of the Bankruptcy Act, as amended (U. S. C., title 11, sec. 22 (a)), provides:

> Any person, except a municipal, railroad, insurance, or banking corporation or a building and loan association, shall be entitled to the benefits of this Act as a voluntary bankrupt.

Section 141 of the Bankruptcy Act, as added by section 1 of the Act of June 22, 1938, 52 Stat. 887 (U. S. C., title 11, sec. 541), provides:

> Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied.

Section 146 of the Bankruptcy Act, as added by section 1 of the Act of June 22, 1938, 52 Stat. 887 (U. S. C., title 11, sec. 546), provides, in part:

> Without limiting the generality of the meaning of the term "good faith", a petition shall be deemed not to be filed in good faith if— * * *
>
> (3) it is unreasonable to expect that a plan of reorganization can be effected; or
>
> (4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding.

STATEMENT

Petitioner Fidelity Assurance Association is a West Virginia corporation with its principal place of business in Wheeling, West Virginia (R. 5, 363–364). From November 1912 to the end of 1940, under the name of Fidelity Investment Association, it was engaged exclusively in the business of selling its own securities in the form of investment contracts (recently known as face-amount

certificates) and in investing and reinvesting the proceeds of such sales (R. 5, 364). It sold 6 different series of contracts at various times in 29 states and the District of Columbia (R. 7, 365–366, 368).[2] Some of the contracts carried insurance features, but the insurance risks were carried by an insurance company to which Fidelity paid premiums, and not by Fidelity (R. 6, 19, 368–369, 370). Fidelity contracted to segregate the proceeds of contracts of each series (less expense deductions) for the benefit of contract holders of that series. It kept books showing the status of the several series separately, and particular securities acquired were allocated to the various funds (R. 9).

The State of West Virginia required Fidelity to deposit, as security for its obligations to contract holders, property of a value equal to $100,000 more than the company's net cash liability on all its outstanding contracts, less the amount of similar deposits required by other states. West Virginia Code, c. 33, Art. 9, sec. 3. Fourteen other states require some sort of deposit (R. 7–8, 365). The property thus deposited by Fidelity constitutes about 95 per cent of its assets (R. 366). The state depositaries did not segregate the deposited securi-

[2] There are outstanding contracts in the face amount of $181,948,026.70, representing a net cash liability of $23,475,668.67 owed to approximately 88,000 holders (R. 366). Holders of such contracts now reside in each of the 48 states, the District of Columbia, and foreign countries (R. 366).

ties according to series even where they had notice of the particular series of contracts to which the deposited securities belonged (R. 9). In five states the local statute excludes nonresident contract holders from participating in the local deposit; in other states it is not clear that nonresidents have no interest.[2] The statutes do not expressly indicate whether the measure of claims against the deposits is the amount paid in at the cash surrender value, the reserve value of the contracts, or some other amount.

At least as early as 1940 Fidelity was insolvent. It could not meet the reserve requirements for face-amount certificate companies contained in section 28 of title I of the Investment Company Act of August 22, 1940, 54 Stat. 829 (U. S. C., title 15, sec. 80a–28) (R. 11, 367, 369). On December 31, 1940, the day before that statute was to become effective and its reserve requirements become applicable to Fidelity, it amended its charter so as to obtain insurance powers, at the same time changing its name to Fidelity Assurance Association; this amendment was designed to avoid the requirements of the Investment Company Act, which do not apply to insurance companies (R. 11, 19–20, 340–341, 367, 369). Fidelity received a license to

[2] There is also uncertainty under most statutes on the question of who are residents: whether the deposits secure persons residing in the state at the time of sale of the contracts, persons residing in the state at the time the deposit is made, or persons now residing in the state.

do business as an insurance company from January 1, 1941, to April 1, 1941, upon an understanding with the Auditor of West Virginia (*ex officio* Commissioner of Insurance) that it would engage in no business until he gave it permission to do so (R. 11–12, 369–370).[4] Subsequently, without an authorization from the Auditor, it sent out riders to its series B contract holders assuming direct liability on the insurance provisions of the series B contracts, continuing, however, to pay premiums to the insurance company which had theretofore carried these risks (R. 341–343, 370). It wrote no new investment contracts after December 31, 1940, but it continued to service existing contracts (R. 11–12).

The insurance license expired March 31, 1941. Application for a renewal of the license was made, but no renewal was granted. The Auditor of West Virginia on April 4, 1941, directed Fidelity to discontinue the transaction of all business. On April 11, 1941, the Circuit Court of Kanawha County, West Virginia, appointed receivers for Fidelity on a petition filed by the Auditor with a view to reorganization. (R. 12–13, 249–258, 370.) One of the receivers is a member of the law firm which represented Fidelity, and this firm now acts

[4] Fidelity also agreed to write no more investment contracts, although its license to issue face-amount certificates did not expire until April 1, 1941 (R. 11, 370).

as attorneys for the receivers (R. 32, 139–140, 314).[3] Other receivership proceedings were begun in eleven other states (R. 13, 370–371).

On June 6, 1941, Fidelity filed a voluntary petition under Chapter X of the Bankruptcy Act in the District Court of the United States for the Southern District of West Virginia. The court then appointed a trustee, enjoined the various state receivers and others from disposing of Fidelity's property in their hands, and ordered the receivers to deliver to the trustee the property of Fidelity which they held. The court later ordered state officials holding deposits of Fidelity's property to deliver them to the trustee. The state receivers and depositaries were permitted by the court to intervene and file answers controverting the allegations of Fidelity's position. Extended hearings were held, during which the court rescinded its turn-over order with respect to state depositaries (R. 3–4, 319–334, 371).

At the conclusion of the hearing the District Court approved Fidelity's petition and overruled motions to rescind its standing turn-over and freezing orders (R. 38–40). The Circuit Court of Appeals reversed, holding (1) that Fidelity was

[3] The District Court found that the history of Fidelity has been marked by extravagance and other serious mismanagement (R. 29). A number of its officers and directors are under indictment for violations of the Securities Act of 1933 and the federal mail fraud statute.

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an insurance corporation and therefore not eligible for reorganization under Chapter X of the Bankruptcy Act, and (2) that the petition had not been filed in good faith; rehabilitation of Fidelity not being reasonably possible, continuation of the prior state-court receiverships for liquidation purposes would serve the interest of creditors better than proceedings under Chapter X (R. 363–388).

ARGUMENT

I

Fidelity's business before December 31, 1940, was unquestionably that of an investment company selling face-amount certificates, and not that of an insurance corporation. Clearly, if it had then sought Chapter X reorganization it would have been held eligible. The fact that at the end of 1940 it changed its name from Fidelity Investment Association to Fidelity Assurance Association, procured a charter amendment conferring insurance powers, and obtained a license to do insurance business with the understanding that it should do none except with specific permission from the state licensing official should not alter Fidelity's status. Its sole business of substance continued to be investment contracts. Such insurance business as it later purported to transact, without the West Virginia Auditor's authorization, was insubstantial; its assumption of liabil-

ity on the insurance features of some of its contracts was only secondary, so that it incurred no real risks, since Lincoln National Life Insurance Company continued to insure these contracts on a policy maintained by Fidelity.[3]

The Circuit Court of Appeals, however, held that Fidelity's status for purposes of the Bankruptcy Act was to be determined not by its predominant business activity (pursuant to which it had acquired all its assets and incurred all its substantial liabilities) but by its charter powers and classification under state law, although this status on which the court relied was assumed only after Fidelity had gone virtually out of business (see R. 372–373, 376, 379). The court believed that under the laws of West Virginia (and of most of the states in 1910, when Congress inserted the present excepting clause in section 4 of the Bankruptcy Act) Fidelity was an insurance corporation with incidental annuity powers at the time of filing its petition for reorganization. The rule that classification of a company for purposes of state regulation is determinative of its status under the federal Bankruptcy Act was rested by the court on the theory that Congress had excluded "insurance

[3] In its dealings with the Virginia Corporation Commission Fidelity specifically stated that it had issued no insurance policies, pointing out that the riders sent to series B contract holders created no insurance risks (R. 359–360).

corporations" from federal corporate reorganization because companies in such a category were comprehensively regulated during their active existence by state laws and should be similarly administered in case of rehabilitation or dissolution; to determine whether a particular company fell within the class it was necessary to inquire concerning its classification under the applicable state law (see R. 374–378). The soundness of this *rationale* in the present case disappears when it is noted that face-amount certificate companies in West Virginia were subject to regulation similar to and as comprehensive as that applied there to insurance corporations and were subject to identical liquidation procedures (see R. 124–130; Pet. 52–56). Unquestionably, an investment company under state law is eligible for reorganization under Chapter X.

The decision of the Circuit Court of Appeals that Fidelity's charter powers and classification under West Virginia law govern its eligibility for reorganization conflicts with the decision of the Circuit Court of Appeals for the Sixth Circuit In re *Roumanian Workers Educational Ass'n of America*, 108 F. (2d) 782. The view of the Sixth Circuit, that the character of activity actually carried on is the important criterion, is the view taken by legal writers. Finletter, *Law of Bankruptcy; Reorganization* (1939) 107; Note, *Bankruptcy; Corporate Reorganization: Survey of*

Chapter X in Operation (1941), 18 N. Y. U. L. Q. Rev. 399, 402.[1]

In addition, the first question presented by this case is one for certiorari because of its importance in the administration of federal statutes. It involves the eligibility for and amenability to corporate reorganization under Chapter X of face-amount certificate and other investment companies which procure incidental insurance powers, making insubstantial use of them. Fidelity alone has in excess of $20,000,000 of assets; other similar companies are also large financial institutions which have attracted the savings of large numbers

[1] The court below referred to cases in other circuits as supporting its rule (see R. 375–379). Those cases contain statements that charter power and state classification constitute the controlling consideration. *E. g.*, In re *Union Guarantee & Mortgage Co.*, 75 F. (2d) 984, 985 (C. C. A. 2); *Woolsey* v. *Security Trust Co.*, 74 F. (2d) 334, 335, 337 (C. C. A. 5); *Security B. & L. Assn.* v. *Spurlock*, 65 F. (2d) 768, 771 (C. C. A. 9); *Kansas* v. *Hayes*, 62 F. (2d) 597, 599–600 (C. C. A. 10); *Clemons* v. *Liberty Savings & Real Estate Corp.*, 61 F. (2d) 448, 450 (C. C. A. 5). It is to be noted, however, that in most of the cases the decisions were equally consistent with the view that business actually done should be the controlling factor. *Woolsey* v. *Security Trust Co.*, *supra*; *Security B. & L. Assn.* v. *Spurlock*, *supra*; *Kansas* v. *Hayes*, *supra*; *Clemons* v. *Liberty Savings & Real Estate Corp.*, *supra*. Charter power and state classification have in fact been determinative in only two situations: (1) where there is the possibility that activities carried on *ultra vires* affect the corporation's amenability to bankruptcy (*Gamble* v. *Daniel*, 39 F. (2d) 447 (C. C. A. 8)), and (2) where the activities carried on do not fall within an easily recognized category (In re *Prudence Co.*, 79 F. (2d) 77 (C. C. A. 2); In re *Union Guarantee & Mortgage Co.*, *supra*). Clearly, neither of those situations exists in Fidelity's case.

of persons throughout the United States for investment.[*] As we endeavor to point out in part II of this memorandum (*infra*, pages 14–16), it is a matter of considerable consequence whether such companies are reorganized in a single federal proceeding or their affairs are settled piecemeal in numerous state proceedings.

The decision below, by pointing out a way in which face-amount certificate companies may avoid bankruptcy, also interferes with the applicability of section 67 (f) of the Bankruptcy Act, as added by section 29 (a) of title I of the Act of August 22, 1940, 54 Stat. 835 (U. S. C., title 11, sec. 107 (f)), providing for the avoidance in certain cases, by the trustee in bankruptcy, of deposits made with state officials by face-amount certificate companies and providing for the distribution in bankruptcy of such deposits. This section is applicable to face-amount certificate companies as defined in section 4 of title I of the Act of August 22, 1940, 54 Stat. 799 (U. S. C., title 15, sec. 80a–4 (1)). Section 3 (c) (3) of title I of the same act excepts insurance companies from the category. 54 Stat. 797 (U. S. C., title 15, sec. 80a–3 (c) (3)). Thus the holding of the Circuit Court of Appeals reaches so far as the coverage of the Investment Company Act of 1940.

[*] It is significant that the Investment Company Act defines an insurance company as one "whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies." Section 2 (a) (17) of title I of the Act of August 22, 1940, 54 Stat. 790 (U. S. C., title 15, sec. 80a–2 (a) (17)).

II

The court below held also that Fidelity's petition was not filed in good faith within the meaning of section 146 of the Bankruptcy Act. It adverted to the unlikelihood that a plan of reorganization of Fidelity as a going concern could be effected (R. 382–384). If the court's ultimate conclusion that the petition lacked good faith is to be construed as embodying a holding under section 146 (3) of the statute, we think that this Court should grant review of that question. The apparent view of the Circuit Court of Appeals that rehabilitation of the debtor must be in prospect (see R. 383, 384) conflicts with decisions that a plan for slow and orderly liquidation meets the requirements of section 146 (3). In re *Porto Rican American Tobacco Co.*, 112 F. (2d) 655 (C. C. A. 2); *R. L. Witters Associates* v. *Ebsary Gypsum Co.*, 93 F. (2d) 746 (C. C. A. 5); In re *Central Funding Co.*, 75 F. (2d) 256 (C. C. A. 2).

The Circuit Court of Appeals clearly held that the petition lacked good faith because the pending proceedings in various states would best subserve the interests of creditors. The statutes governing those proceedings (see R. 40–57, 203–209; Pet. 52–56) are liquidation and receivership statutes of the type customarily applicable to banks, insurance companies, and other financial corporations. In general the receivers would have jurisdiction

over only the assets in the states of their respective appointment, and would have no power to bring suit to secure assets and surplus deposits in other states. *Booth* v. *Clark*, 17 How. 321, 339; *Great Western Mining Co.* v. *Harris*, 198 U. S. 561; *Lion Bonding Co.* v. *Karatz*, 262 U. S. 77. Nevertheless the court below concluded that continuation of the state proceedings would best subserve the interests of the creditors because (1) it did not clearly appear that there would be any surplus in any state other than West Virginia; (2) the manner of distribution of funds in each state had to be determined in any event according to state law; and (3) creditors could as well file claims for the West Virginia surplus in a West Virginia state court as in the federal court for West Virginia having jurisdiction of these proceedings.

In reaching this conclusion the court below failed to give due weight to circumstances which should be controlling:

(1) There is need in this case for the impartial investigation, into the acts of the management, by an independent trustee (as required by section 167 of the Bankruptcy Act), looking to recoveries for the benefit of creditors. The past history of Fidelity is marked by extravagance and other serious mismanagement. Many of its officers are now under indictment. The general advantages of Chapter X as a reorganization statute have been pointed out by this Court in *Securities and Ex-*

change Commission v. *U. S. Realty & Improvement Co.*, 310 U. S. 434. These advantages are particularly clear as against the state procedures in this case, where one of the West Virginia receivers is a member of the law firm which has been counsel to Fidelity, and is a law partner of one of the Fidelity officers under indictment.

(2) The difficult problems of distribution in this case can best be settled in a single administration. Concededly if the respective state deposits were distributed to local creditors there would probably be no surplus in any state other than West Virginia (with the possible exception of Wisconsin, where the assets appear to be worth more than the cash value of the contracts held by Wisconsin residents). But, before there can be any conclusion that no part of the assets in any state is available to contract holders not resident in that state, the following difficult questions must be settled:

(a) It must first be determined whether the state deposits are solely for the benefit of local residents, and not for the benefit of all contract holders. In West Virginia, where clearly nonresidents have an interest in the deposit, it must be determined whether West Virginia creditors have a preferential interest.

(b) It must be determined whether the local deposit is for the benefit of contract holders who resided in the state when their contracts were

sold, who resided there when the deposits were made, or who now reside in the state.

(c) It must be determined whether the measure of claims is the cash value of the contracts, the reserve value, the amount necessary to mature the contracts, the amount paid in, or some other amount.

(d) It must be determined whether states which accepted deposits from Fidelity to secure contracts in a particular Fidelity series, with knowledge that the securities deposited constituted a fund belonging by contract to another series, may keep such assets.

It is obvious that security holders from states without deposits or states with inadequate deposits, must litigate these questions in each of the fifteen states having deposits unless there is to be a central administration in a court of bankruptcy. The facile distributions mentioned in the briefs in opposition filed by respondents (W. Va. Br. 34, 37; Tenn. Br. 16–19) would be effected only by disregarding these questions. We think there should be a central administration even though the questions must be determined according to state law, as remarked by the Circuit Court of Appeals (R. 386).[10]

[10] Federal courts are frequently called upon to determine questions of state law in cases arising because of diversity in citizenship of the parties. *Erie R. Co.* v. *Tompkins*, 304 U. S. 64. The coordinate constitutional jurisdiction of the federal

The question of the weight to be given to factors such as those set out above in determining whether the interests of the creditors will be best subserved by the continuation of prior state proceedings is one of importance. This Court recently granted certiorari in a case presenting similar problems. *Marine Harbor Properties, Inc.*, v. *Manufacturers Trust Co.*, No. 24, October Term, 1942, certiorari granted, 315 U. S. 794.[11] Unlike the situation in the *Marine Harbor* and *Paloma Estates* cases, the property of the debtor here is not all located in a single jurisdiction, but is spread through many.

CONCLUSION

The Circuit Court of Appeals erred in holding that the petition for reorganization should be dismissed. Its decision conflicts with the decisions of other circuit courts of appeals in holding that petitioner Fidelity Assurance Association was an insurance corporation in 1941 and that the petition was not filed in good faith. The questions presented are important and warrant consideration by this Court. It is therefore respect-

courts in bankruptcy cases should not remain unexercised under a permissive statute merely because questions of state law are raised. The nature of Chapter X and of other Bankruptcy Act proceedings is such that these questions are normally raised.

[11] Another similar case, In re *Paloma Estates, Inc.*, No. 89, October Term, 1942, is pending on petition for writ of certiorari.

fully submitted that the petition for certiorari should be granted.

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